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Dear Anna,

Working paper #1: setting the default tariff cap

Please find our comments on your first working paper on the forthcoming default tariff price cap. This submission is entirely non-confidential and may be published on your website.

The most significant of the issues contained in this working paper is the choice of which of four possible methodologies could be used to set the cap. We broadly agree with the overview of these options and the pros and cons of each, although we may have a slightly different view on one design consideration and think one further factor should be considered when making the choice.

Design considerations

The area where we may have a slightly differing view is in relation to the temporary nature of the cap. Para 3.3 sets out that 'the cap should be designed in a way that reflects its intended (temporary) lifespan,' implying that you may have proportionality concerns on how detailed, robust or future-proof its design needs to be, particularly in the context of needing to get something in place quickly.

While we acknowledge that the price cap is explicitly time limited by the Bill, it could still potentially be in place for as long as five years, to 2023. We are also mindful that both the minister, Claire Perry, and your Chief Executive, Dermot Nolan, have made public comments suggesting a common view that some form of enduring price protection may be needed for vulnerable consumers after the wider cap ends. It seems plausible that enduring protection could evolve out of, or represent a continuation of, the default tariff cap that you are now developing. Because of these factors, we would encourage Ofgem to try and develop the methodology as though it was a 'business as usual' permanent regulatory requirement and not a short term stopgap, and to try and make it as future proof as possible. We think this would form a least regrets pathway, although we acknowledge you are acutely time constrained in what development work you can do while still getting protections in place for the coming winter.

The additional design consideration we think is relevant is consistency with the prepayment meter (PPM) price cap. The Bill does not require Ofgem to adopt a similar methodology for the wider default cap to the one that is in place for PPMs. But we think it would be desirable to maintain consistency where you can. The greater the methodological difference between the two is, the higher the chances are that movements in the two caps may become divorced. In extremis, this could create a communications or trust problem, for example if one cap was moved up or down by a much larger amount than the other during the periodic recalculations. Beyond this, there may be economies of scale to suppliers, and benefits in terms of stakeholder comprehension and communication, resulting from the consistent application of the two caps.

The four options

We think you are right to constrain yourself to the four methodological options identified, and given the tight timeline to get to implementation we would encourage you to only narrow them from this point and not to open up any further options.

We see options 2 to 4 as methodologically similar, but with 3 being more time consuming than 2 to develop and implement, and 4 likely being much more challenging still. We think it is highly likely that either option 3 or 4 will deliver a more accurate assessment of current and ongoing costs than option 2 because they would use more up to date cost data than it would. But it is not clear that option 4 would provide a better model than option 3 - both are effectively bottom up estimates of suppliers cost to serve. That you included the more logistically challenging option 4 implies that you do see it as having potential accuracy or robustness benefits over the alternatives but these were not obvious to us as a consultee - so if it is the approach you ultimately settle on we would encourage you to draw out your thinking on why in greater detail in your subsequent consultations.

On options 3 and 4, we would caution against making too heavy reliance on the CSS when deriving the benchmark. It must be remembered that the CMA's finding was one of significant inefficiency in the sector incumbents - which will be reflected in the costs that it shows. You highlight that the CMA adopted a lower quartile approach in its own calculations of an efficient or challenging baseline and we would suggest you may wish to do similar - and from a group that considers all suppliers who are not subject to policy cost exemptions, not simply the Big 6.

In the event you adopt a costs driven approach we support the approach to setting wholesale costs you set out in the paper, which is broadly consistent with the approach used for the PPM cap.

We see policy costs, at the moment particularly in relation to smart metering, as the hardest area to efficiently gauge costs, because they are potentially fast moving, relatively opaque, and an area where there is significant pre-existing dispute between suppliers and policymakers on their actual level. We are not in a position to meaningfully assist in adjudicating that dispute, but we would encourage you to flesh out and evidence your understanding of these costs as far as you can in the remaining weeks that you have to develop the methodology. We would also encourage you to consider publishing these costs, broken down by policy, on an ongoing basis. That information would help to manage stakeholder expectations on likely movements in the cap in a way that is less necessary for other cost components (eg wholesale prices and network charging methodologies are already in the public domain). It would also be useful more generally in enhancing public understanding of cost drivers, particularly given how frequently suppliers have attributed pricing decisions to policy costs.

Our views on the basket of tariffs approach, option 1, are largely unchanged from those we expressed when that option was explored as part of your February consultation on the vulnerability cap.[1] In a nutshell, we agree that there are significant conceptual advantages in an approach that is led by price data rather than cost data, as it would remove some of the information asymmetries, and might remove some of the efficiency assumptions, that are inherent in a cost data led approach. It might reasonably be regarded as 'softer touch' and less intrusive (to suppliers) than a cost data led approach. But while those are all highly attractive characteristics to the approach, it remains extremely hard to see how you could define a basket of tariffs that is a reasonable proxy for an efficient cost to serve default customers and that could remain robust over five years.

If the basket is based on the top of the best buy tables then by definition its contents are likely to be quite unlike SVTs. Market leading tariffs are disproportionately likely to contain one or several of the following characteristics: be fixed term; be fixed price; be for direct debit customers; be online billing only; have exit penalties; be with suppliers who do not offer the Warm Home Discount; and be from suppliers who are exempt from some policy costs. While many of these deals are offered by suppliers who have sustainable business models, that cannot be assumed in all cases, particularly given recent market exits. Because of this, like for

[1] We append our February submission to this letter.

like comparison with SVTs will be crude at best. Ofgem would need to work out how to adjust for those differences.

In theory, some of those issues could be mitigated by trying to form a basket using prices derived from mid tier suppliers who are not subject to policy cost exemptions, where there is a higher degree of confidence of sustainable pricing, and where there is a reasonable amount of confidence of efficiency (noting the CMA's benchmark was derived from First Utility and Ovo, and that the pricing of mid tier SVTs suggests particular efficiencies at that scale[2]). There may be issues around the liquidity and gameability of such a basket though; it might only be populated by a small number of suppliers.

Our views on the number of tariffs that should be contained in the basket, on how you could identify and exclude unrepresentative outliers, on whether only certain lengths of fixed deals should be included, and whether there should be limits on how many of an individual supplier's tariffs that can be included in the basket, are unchanged from February.[3]

Despite those reservations, we do find it plausible that the basket approach could be made to work. We think there may be value in your publishing a more developed model setting out your working assumptions on what would, and would not be included in the basket and any adjustments to the outturn price that would be made. This may make the potential outcomes, and any strengths and weaknesses, more tangible than they currently are to stakeholders and help both you and them to work through the practicalities of implementation. It may also help to alleviate any concerns that this approach might be gameable by allowing people to work through how the cap would respond to pricing movements.

If option 1 is further developed, we would also like to see you explain the interaction between the basket and any headroom that is set on the cap. We anticipate based on public statements that Ofgem will wish to include headroom in the overall cap, in order to maintain a spread of deals in the market. But if the basket approach contains adjusters (eg to allow for the additional costs faced by suppliers who are not exempt from some policy costs), or is not derived from the very top of the best buy tables, then implicitly it may already allow for a significant spread of deals on the market even were headroom set at zero.

[2] For example, past analysis by Cornwall Insight suggested that medium sized suppliers were pricing their SVTs lower than both large and small suppliers, and below the level that might be implied by the adoption of an option 2 approach to setting the price cap. See 'A red rag to a bull: price rises and the proposals for further regulatory intervention,' Cornwall Insight, 25 April 2017. https://tinyurl.com/y8ynelso

[3] See pages 13 and 14 of that submission.

Payment methods

In para 1.6 you highlight that Ofgem will consider whether different caps should be set for different payment methods. We think that it should. There are different costs to serve associated with standard credit and direct debit customers. If these were nugatory, the case for adopting a single blended cap that covered both would be strong on the grounds of simplicity and ease of implementation. In its February consultation on the vulnerability cap, Ofgem noted that a range of plausible approaches for estimating cost to serve differentials could give very different figures, and that suppliers have some discretion on allocating their costs, which may mean that the gap between the two payment methods is not as wide as is generally thought.

But the most definitive figure that is currently available is the ~£100 gap calculated by the CMA, however. This is sufficiently material that we think it may be unsound to apply a single blended cap. It could result in competitive distortions between suppliers depending on the payment method make up of their customer base. It may also result in a cap that is unreasonably generous to suppliers in terms of the return they can make on direct debit customers, while unreasonably tight in terms of the return they can make on standard credit customers, with the potential for unintended knock-on consequences on eg customer service.

Evolution of the cap

The cap will need to evolve during the period in which it is in place, and not simply in terms of the calculation being re-run at least once every six months. Most obviously, this should be in relation to supplier inefficiency.

The CMA found that, on average over the years 2012 to 2015, consumers were paying £1.4bn/year more than they would under an effectively functioning market. The situation was deteriorating over time, and reached £2bn/year in 2015. Just over half the average annual excess, £750m, related to inefficiency.

Part of the function of this default tariff cap must be to try and drive out this inefficiency and not simply to allow it to be passed through to consumers. It therefore needs to be challenging for the least efficient suppliers to beat the cap. At the same time, it is unrealistic to expect that all these inefficiencies can be driven out in a single year and there may be supplier solvency issues if this is attempted. Because of this, it may be appropriate to design in a mechanism that allows the steady tightening of the cap over its lifespan to drive year-on-year efficiency improvements rather than a 'big bang' one-off slashing of costs. This could be

achievable through a CPI-X annual adjustment to allowable supplier costs (under options 2 to 4) or to any adjustment to the tariff basket (under option 1). Alternatively, headroom could be deflated over time, which would be conceptually clumsier but could achieve the same net effect.

More broadly, with the potential for the cap to be in place for five years, and with the energy sector in a period of rapid evolution, there is likely to be the need to amend the initially developed methodology at some points during its lifespan. While the government has been clear that it will not introduce a right of appeal to the CMA in relation to the introduction of the price cap, it is less clear to us that such a right of appeal will not exist by default in relation to any subsequent changes to the methodology, given that any change to a licence is usually appealable under existing legislation. We would welcome clarification from Ofgem on whether it interprets pre-existing appeal rights as being in place for any subsequent amendments to the methodology and whether it has implications for the implementation approach (for example, on what sits in the licence and how prescriptive it is).

Yours sincerely

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